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C O N F I D E N T I A L SECTION 01 OF 03 RIO DE JANEIRO 000288

SIPDIS

STATE FOR WHA/EPSC, MMCANUS, BDUGGAN  
NSC FOR RACHEL WALSH, LUIS ROSSELLO  
FOR DOE GWARD, RDAVIS, LEINSTEIN, RROSS  
STATE PASS USTR KDUCKWORTH  
DOC FOR ADRISCOLL, LFUSSELL, MCAMERON

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SUBJECT: RIO'S OIL PLAYERS REACT TO SPECULATION ON PRE-SALT  
REGULATIONS

REF: BRASILIA 1021

Classified By: Consul General Dennis W. Hearne. Reasons 1.4 (b,d).

SUMMARY

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¶1. (C) While the Government of Brazil (GOB) has yet to publicize its regulatory framework for the exploration of pre-salt reserves (reftel), Petrobras executives, petroleum industry representatives, and Rio de Janeiro-based managers of American oil firms have expressed concern over the main provisions of the reform package reported in the press. In reaction to the likelihood the new framework will mandate Petrobras as the sole operator for all unlicensed blocks, Petrobras and Brazilian Institute for Petroleum executives argued the company does not have sufficient resources to effectively carry out this role, which could lead to subcontracting opportunities for other oil firms. While petroleum companies praised the concession model under the existing regime and opposed the likely shift to production sharing contracts (PSC), some analysts argued PSC provisions could potentially carry fiscally advantageous terms for investors. The possibility of a new state company to own and administer all pre-salt reserves is anathema to industry representatives in Rio de Janeiro, although there appears to be a sound legal justification for such an entity. Local representatives of Chevron and Exxon Mobile are bracing for a far more challenging operating environment, but both companies will maintain an active presence in Brazil, regardless of the changes the new reform package brings. End Summary.

PETROBRAS AS SOLE OPERATOR

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¶2. (C) In reaction to the widely-accepted perception that the new framework will mandate Petrobras as the sole operator for all unlicensed blocks, Petrobras and Brazilian Institute for Petroleum (IBP) executives in Rio de Janeiro contend the company does not have sufficient resources to effectively carry out this role. Fernando Jose Cunha, General Director of Petrobras for Africa, Asia, and Euroasia, told Rio Econoff on Monday August 17 that such a provision, along with the strong likelihood Petrobras will also be guaranteed at least a 30 percent share in every block, could deter potential investors and partners. Alvaro Teixeira, General Director for IBP, an industry association that represents Petrobras

and other petroleum companies operating in Brazil, called the proposal a "bad idea," stating the GOB would first have to recapitalize Petrobras. According to Gustavo Gattas, a prominent energy analyst with UBS Pactual, Petrobras' lack of resources will likely lead to extensive contracting for pre-salt exploration and production operations. He explained that some companies stand to benefit more than others from this model, explaining many IOCs and oil services company consider Petrobras to be one of the "harshest" contractors in the world. "Some people are comfortable working with Petrobras, others are not," he explained.

13. (C) Reaction by Rio de Janeiro-based representatives of American oil companies to the possibility of Petrobras as the sole operator is mixed. Exxon Mobile's External Relations Director Carla Lacerda, told Rio FCS officer on August 10 the proposed model constituted a reversion to Brazil's former monopoly system. As the sole operator, she explained, Petrobras would have more control over equipment purchases, personnel, and technology selection, which, in turn, could adversely affect U.S. equipment and service supply to Brazil.

Chevron's Director for Business Development and Government Relations Patricia Pradal told Rio Econoff on August 21 that she had doubts over the legality of such a provision. "The Brazilian government will have to fight this out in the courts or change the shareholder composition of Petrobras to give the government a greater share," she explained. In spite of that possibility, Pradal did not believe non-operating partner status would necessarily be bad for Chevron. She stated, "We are trying to maintain a lower profile nowadays," adding, "We area already partnering with

RIO DE JAN 00000288 002 OF 003

Petrobras on five projects here."

MOVE FROM CONCESSION TO PRODUCTION SHARING CONTRACTS

14. (C) Although industry is opposed to the likely shift from concession to production sharing contracts (PSCs) under the new regime, PSC provisions could potentially carry fiscally advantageous terms for investors. IBP's Teixeira and Chevron's Pradal praised the concession model under the existing regime, calling it "strong and stable." Pradal said the shift from such a model to a PSC was a political move, explaining "Everything the Brazilian government is trying to get from a PSC, they could have done through concessions." USB Pactual's Gattas offered a more favorable view on PSCs, however, explaining the new model could erase the upfront cash payments associated with current concession contracts. The Tupi field, for example, required an upfront payment of 15 million Brazilian Reals (8 million USD). Gattas also explained that new provisions could possibly allow companies to recover a greater percentage of their investment within the first years of production. "A quick pay back under a PSC can be very attractive to many IOCs," he explained.

FORMATION OF NEW STATE COMPANY

15. (C) The likelihood of a new state company to own and administer all pre-salt reserves is anathema to industry representatives in Rio de Janeiro. Petrobras' Cunha stated Petrobras never agreed with the concept of a new state company. With Petrobras already at capacity, he did not know how such a company would receive its financial and human capital. "Will we be robbing Peter to pay Paul?," he asked rhetorically. Chevron's Pradal said the GOB's motivation for creating such a company was based on political jockeying, stating, "The PMDB needs their own company." (Note: The PMDB, the government's coalition partner, has reportedly been negotiating with President Lula's PT party for seats on the board of such a company, in exchange for political concessions going into an election year. Energy Minister Edison Lobao, who is a leading PMDB member, was a key proponent of the new state entity. End note). According to

USB Pactual's Gattas, however, it makes legal sense for the GOB to form a body to serve as a contract counterparty in court disputes and PCS re-negotiations." IBP's Teixeira said such a company will consist of less than 100 personnel, and would receive technical support from the Ministry of Mines and Energy.

#### UNITIZATION AND LOCAL CONTENT

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¶6. (C) There is mixed reaction over whether unitization and local content requirements will be included in the new framework. While some industry players have speculated the regulations will address unitization, a term of art in the petroleum industry for the process of distributing unlicensed blocks that share reservoirs with licensed blocks already under concession, Nelson Narciso Filho, Director for the Brazilian National Petroleum Regulatory Agency (ANP) stated the new regime will not address the unitization issue (Note: ANP is responsible for administering unitization. End Note).

"We should not touch unitization until after the new regulations are in place," he said. While the Ministry of Mines and Energy Undersecretary for Oil, Natural Gas, and Renewables told Brasilia Econoff that the new regulations will provide for a flat local content requirement for all blocks (reftel), as opposed to local content factoring into bidding criteria under the concession system, USB Pactual's Gattas doubted this would be the case. (Note: At the July 20 CEO Forum, an attendee of Presidential Chief of Staff Dilma Rousseff's meeting with the Brazilian CEOs told Brasilia Econoff that an increase in local content requirements would be part of the new pre-salt regulations. End Note). Gattas explained local content requirements are already too high for the Brazilian equipment companies. "Everyone is fully contracted right now," he stated, "And this could go overboard." He argued such requirements would not be

RIO DE JAN 00000288 003 OF 003

addressed in the law, but rather handled through individual contracts, perhaps based on the precedence of the first PSC to fall under the new framework.

#### AMERICAN OIL COMPANIES: 'WE WILL STAY'

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¶7. (C) Although Rio de Janeiro-based representatives of Chevron and Exxon Mobile are bracing for a far more challenging operating environment, both companies will maintain an active presence in Brazil, regardless of the changes the new reform package brings. According to Exxon Mobile's Lacerda, the Brazilian market remains attractive, especially considering declining access to reserves, world wide. Chevron's Padral conceded her company will be "struggling" in the coming years, but said existing investments and her company's long-term goals here will keep Chevron engaged. "The rules can always improve later on," she said. Both Lacerda and Padral stated their companies were accustomed to PSCs world-wide and would enter into them here, given competitive and transparent terms.

#### COMMENT

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¶8. (C) Petroleum actors and insiders in Rio de Janeiro uniformly view the pre-salt reform as pre-election politicking by the Lula Administration. Given the fact that the GOB has not yet publicly released details of the new regulatory framework, however, industry is tempering its reaction to the actual terms of the framework until after its announcement in Brasilia on August 31. Ultimately, the pace of production the GOB subsequently sets for the pre-salt reserves could influence the IOC's ability to develop these fields more than the actual terms that govern how they do so.

¶9. (C) Even once the announcement of the government's vision of a new regulatory framework is made next week, it will still be a government proposal that needs the approval of the

Congress. Given the highly politicized nature of Congressional debate as Brazil anticipates the coming election year, a bill as important as this one will not face an easy road to approval. The final product will likely be substantially different than the details that have been leaked. For example, press reports varied leading up to the announcement, from Minister Lobao indicating that the distribution of royalties to states and municipalities will be omitted from the August 31 proposal so that the issue does not hold up passage of the rest of the legislation, to other reports that the GOB, under pressure from oil producing states, will in fact include royalties in the new framework, in a formulation closer to the current scheme. Such a decision which would almost certainly create disappointment and controversy among the non-oil producing states. Sources at the Ministry of Mines and Energy confirm that it is still unclear how this issue will be handled vis-a-vis the August 31 announcement. While this element of the new regime is not one that has concerned industry thus far, it is clearly one of the biggest headaches for the government and likely to produce the toughest battles for the government. The fact that this very issue already prompted the delay of the previously planned August 19 announcement, and government consultations with affected state and local leaders in the interim do not appear to have brought them any closer to a resolution, is likely just a harbinger of the difficulties that lie ahead for this part of the new regulatory regime. Post will continue to closely monitor and report on developments. End Comment.

110. (U) This cable has been coordinated with Embassy Brasilia.  
HEARNE